

**MEMORANDUM OF UNDERSTANDING
BETWEEN
THE COMMERCE COMMISSION
AND
THE ELECTRICITY COMMISSION**

PROTOCOL ON TRANSMISSION ARRANGEMENTS

16 AUGUST 2007

(as amended on 13 November 2008)

This Protocol to the Memorandum of Understanding between the Commerce Commission and the Electricity Commission was made on 16 August 2007, and updated on 13 November 2008 to reflect:

- amendments made to the Commerce Act 1986 by the Commerce Amendment Act 2008; and
- Transpower's administrative settlement, accepted by the Commerce Commission on 13 May 2008.

Background

- A. This protocol forms part of a Memorandum of Understanding between the Commerce Commission and the Electricity Commission dated 16 August 2007. The Memorandum of Understanding explains how the two Commissions coordinate their respective roles under the Commerce Act 1986 and the Electricity Act 1992. The original protocol was published on 16 August 2007. This protocol updates the original protocol as a number of substantive matters referred to in the original protocol have been resolved.
- B. In May 2008 the Government, through its Government Policy Statement on Electricity Governance (Government Policy Statement), requested the two Commissions to review the Memorandum of Understanding. The Commerce Commission is required by section 26 of the Commerce Act to have regard to the economic policies of the Government as transmitted in writing from time to time to the Commerce Commission. The Electricity Commission is required by section 172ZK of the Electricity Act to give effect to the objectives and outcomes in the Government Policy Statement.
- C. Paragraphs 117 and 118 of the Government Policy Statement provide:

The Government's economic policy is that investment and other costs in relation to approved grid upgrade plans should be recoverable by Transpower. The Government also wishes to ensure that interested parties have certainty and clarity on how the two Commissions will operationalise the coordination of their respective roles.

Accordingly the Government requests that the Memorandum of Understanding between the Commerce Commission and the Electricity Commission continues to address the following matters in relation to transmission:

- the methodology for determining how each relevant expenditure component in relation to approved grid upgrade plans will be treated over time under the Commerce Act 1986*
- how price setting as regulated by the Commerce Commission interacts operationally with the pricing methodology approved by the Electricity Commission*
- how issues relating to valuation methodologies, pricing and pricing methodologies, quality and information disclosure will be coordinated and harmonised where possible between the two Commissions.*

- D. The Commerce Commission and the Electricity Commission have reviewed the Memorandum of Understanding as requested by the Government through its Government Policy Statement and in light of the Commerce Amendment Act 2008.
- E. The two Commissions consider that, in respect of detailed operational statements regarding the coordination of their respective roles, such as that contemplated by the Government Policy Statement, these statements are best issued as protocols to the Memorandum of Understanding. The reasons for this approach are to:

- (a) ensure consistency with the Memorandum of Understanding as an umbrella document providing a general overview of the respective roles of, and the interrelationship between, the two Commissions; and
 - (b) facilitate the development by the two Commissions of detailed operational statements regarding the coordination of their respective roles without requiring formal amendments to the Memorandum of Understanding each time such statements are issued.
- F. This protocol is intended to ensure that interested parties have certainty and clarity on how the Commerce Commission and the Electricity Commission will operationalise the coordination of their respective roles in relation to transmission matters. The Memorandum of Understanding also provides an overview of the differences between the roles of the two Commissions in dealing with the matters specified in paragraphs 117 and 118 of the Government Policy Statement.

THE PARTIES AGREE

1. Incorporation by reference of protocol into Memorandum of Understanding

- 1.1 The protocol contained in the schedule, as varied from time to time by the two Commissions, is incorporated by reference into the Memorandum of Understanding and remains effective until otherwise agreed.
- 1.2 The two Commissions may amend or revoke the protocol at any time by written agreement between them.

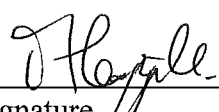
2. Evolving Regulatory Environment

- 2.1 If during the term of the administrative settlement the two Commissions agree that there has been a material change to the regulatory regime applicable to Transpower, they will meet to discuss in good faith the implications of that change for the terms of this protocol, and whether any modification of the protocol is necessary.

SIGNED for and with the authority of the
COMMERCE COMMISSION by:


Signature

SIGNED for and with the authority of the
ELECTRICITY COMMISSION by:


Signature

PAULA REBSTOCK

Name

CHAIR

Designation

DAVID CHAGILL

Name

Chair

Designation

SCHEDULE
PROTOCOL ON TRANSMISSION ARRANGEMENTS

1. Introduction

- 1.1 This protocol describes how the Commerce Commission and the Electricity Commission roles interact and how they coordinate their respective roles under the Commerce Act 1986 and the Electricity Act 1992, particularly regarding the matters referred to in paragraphs 117 and 118 of the Government Policy Statement.
- 1.2 The roles and responsibilities of each Commission are laid out in this document, with the various jurisdictions explained. Close working relations and formal lines of communication have been established to foster sharing of knowledge and coordination of the respective roles. However, for the avoidance of doubt, the Commerce Commission reserves the right to undertake any steps it deems necessary to meet its legal obligations under the Commerce Act, but otherwise, will not review the merits of the investment approvals of the Electricity Commission in relation to transmission.
- 1.3 In summary, Transpower determines its total revenue requirements – covering both existing investments and new investments. The Government has indicated that Transpower should be able to recover, and make an appropriate return on its efficient investments. The Government expects transmission services to be priced as efficiently as possible. Subject to Part 4 of the Commerce Act, the Government further expects Transpower's pricing to customers to be set so as to recover the full economic costs of its services. The Commerce Commission and the Electricity Commission scrutinise Transpower's capital and operational expenditure to ensure that investment is efficient.
- 1.4 The Electricity Commission's role under section III of Part F of the Electricity Governance Rules 2003 (Rules) is to receive from Transpower grid upgrade plans proposed by Transpower comprising investments in the electricity grid disaggregated into reliability investments and economic investments for review and, if appropriate, approval. The Electricity Commission is responsible under section IV of Part F of the Rules for approving and recommending to the Minister of Energy Transpower's proposed transmission pricing methodology (TPM). Provided it uses this methodology, Transpower is entitled to recover its full economic costs in respect of its grid investments from transmission customers, subject only to the constraints in Part 4 of the Commerce Act.
- 1.5 The Commerce Commission had responsibility under Part 4A of the Commerce Act for a targeted control regime and complementary information disclosure regime. This responsibility was exercised by setting thresholds that were intended to act as both incentives consistent with the purpose statement contained in section 57E of the Commerce Act and as a screening mechanism to identify whether further investigation into Transpower's performance was warranted. Part 4A will be repealed on 1 April 2009.
- 1.6 On 13 May 2008 the Commerce Commission published its decision to accept an administrative settlement offer provided by Transpower. The thresholds for declaration of control agreed as part of the administrative settlement were published in the *Gazette* on 27 June 2008 and apply until 30 June 2011. The administrative settlement is preserved post 1 April 2009 by section 54M of the Commerce Act until its expiry (30 June 2011).
- 1.7 It is important to highlight that the constraints that apply to Transpower's overall average prices have been replaced by three new thresholds. These apply constraints to the various inputs into Transpower's annual revenue requirement. The TPM approved by the Electricity Commission has no bearing on how Transpower's annual revenue requirement is derived

(the TPM only determines how the revenue requirement is allocated amongst customers). The Commerce Commission has set thresholds that enable Transpower to recover the full economic costs of transmission services that are efficiently incurred.

- 1.8 The previous quality threshold applying to Transpower remains in force, and one of the three new thresholds constrains the system operator fees to that agreed in contract between the Electricity Commission and Transpower.
- 1.9 The Rules enable the Electricity Commission to approve grid-related investment where such investment is submitted to the Electricity Commission for approval. For replacement and refurbishment expenditure not submitted by Transpower to the Electricity Commission for approval (non Part F capex)¹ the Commerce Commission may provide ex-ante approval to Transpower so as to allow an appropriate level of expenditure to be factored into Transpower's annual revenue requirement.
- 1.10 In regard to grid-related investments approved by the Electricity Commission, the Commerce Commission has discretion to assess the extent and timing of the price set to recover expenditure associated with that investment. The Commerce Commission undertakes this assessment in accordance with its obligations under the Commerce Act.
- 1.11 Unless Transpower breaches its thresholds, any capital expenditure (including grid-related expenditure that Transpower undertakes, as approved by the Electricity Commission) would not be examined further by the Commerce Commission (other than for the purpose of approving Transpower's annual non Part F threshold as agreed in the administrative settlement).
- 1.12 The remainder of this protocol describes in more detail the regulatory structure and the respective roles and responsibilities of the two Commissions. First, Section 2 presents the role of the Commerce Commission and describes the thresholds that it has set for Transpower. The Commerce Commission's decisions relating to expenditure components (specified services) are presented, along with how the revenue requirement is set (and is distinct from the TPM). This is particularly relevant to the question set out in the second bullet point in paragraph 118 of the Government Policy Statement. This protocol also clarifies the Commerce Commission's jurisdiction with regard to regulating service quality. Once the administrative settlement expires, the Commerce Commission's jurisdiction, with respect to Transpower's quality standards, is limited to giving effect to quality standards set by the Electricity Commission.
- 1.13 Section 3 presents the role of the Electricity Commission, with details regarding its processes, responsibilities, limitations, and jurisdictions for reviewing and, if appropriate, approving investments in the grid proposed by Transpower. This section also discusses Transpower's expenditure components under the Electricity Commission's grid investment approval process in accordance with the first bullet point in paragraph 118 of the Government Policy Statement.

¹ Note that the term 'non Part F capex' is the term used in Transpower's administrative settlement proposal which refers to the capital expenditure to be reviewed by the Commerce Commission. Although the term is adopted in this memorandum of understanding to remain consistent with the terminology used in the settlement, it is noted that all such expenditure may be submitted to the Electricity Commission for approval under Part F if Transpower chooses to do so.

- 1.14 Section 4 provides a brief summary of Transpower's performance under the regulatory regime.
- 1.15 Section 5 responds directly to the questions in the third bullet point in paragraph 118 of the Government Policy Statement. This section describes the roles and jurisdictions of the two Commissions with regard to the specific functions discussed.

2. The Role of the Commerce Commission

Part 4 of the Commerce Act

- 2.1 The Commerce Commission has responsibilities under Part 4 of the Commerce Act specifically in relation to suppliers of electricity lines services, including suppliers of transmission services (Transpower), and the 29 suppliers of distribution services.
- 2.2 A principal feature of Part 4 of the Commerce Act is a default/customised price-quality regime under which the Commerce Commission assesses suppliers of electricity lines (except exempt consumer-owned suppliers) services against requirements set by the Commerce Commission and determines whether those requirements have been breached.
- 2.3 Section 52A of the Commerce Act provides that the purpose of the regulatory regime is:
- to promote the long-term benefit of consumers in [regulated] markets by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services:*
- (a) have incentives to innovate and invest, including in replacement, upgraded and new assets;*
 - (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*
 - (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and*
 - (d) are limited in their ability to extract excessive profits.*
- 2.4 The regulatory regime comprises a number of distinct elements as follows:
- (a) determining price-quality paths*, in which the Commerce Commission must set and publish requirements for suppliers that are subject to price-quality regulation, following consultation as to applicable input methodologies with interested persons; and
 - (b) monitoring compliance*, in which the Commerce Commission must monitor compliance with price-quality paths it has set.
- 2.5 The Commerce Commission must set price-quality requirements consistent with section 52A of the Commerce Act and monitor compliance by regulated suppliers against these requirements.

Thresholds applying to Transpower under the administrative settlement

- 2.6 Under the administrative settlement, the thresholds applying to Transpower have significantly changed. The quality threshold will continue to apply to Transpower, however Transpower's price path threshold is replaced with three new thresholds, which are designed to provide clear principles and limits that Transpower is required to adhere to when setting its annual revenue requirement. The three thresholds replacing the price path threshold include:
- a new 'transmission revenue requirement' threshold, as outlined in Schedule 1 of the Notice. This threshold effectively sets the process, principles and limits that Transpower is required to adhere to when setting its annual revenue requirement. This threshold incorporates the outcome of the new Transmission Non Part F capital expenditure threshold into the formula for setting Transpower's annual revenue requirement;
 - a new Transmission ("non-Part F") capital expenditure threshold as outlined in Schedule 2 of the Notice. This threshold sets the process and constraints by which an annual level of capital expenditure will be approved in advance; and
 - a new system operator services threshold, as outlined in Schedule 3 of the Notice. The new system operator services threshold reflects the terms of the existing contract between Transpower and the Electricity Commission.
- 2.7 The transmission revenue requirement threshold requires Transpower to demonstrate that it has applied a set of principles in deriving its annual revenue requirement for the purpose of setting prices for those services that fall within the definition of 'specified services', but excluding the services provided under the System Operator Service Provider Agreement. The principles are those contained in Schedule 1 of the Notice.
- 2.8 The new transmission revenue requirement threshold came into force on 1 July 2008 and remains in force until 30 June 2011. For the period of the settlement, Transpower's base operational expenditure has been set at \$199.61million (in 2006/07), and will be indexed annually using a CPI-X% formula, with X% being zero. As part of the transmission (revenue requirement) threshold, Transpower will use a one-year post-tax nominal WACC of 7.2% for 2006/07 and 7.7% for 2007/08 (using a corporate tax rate of 33%) to calculate any settlement adjustment for those years. It will use a post-tax nominal WACC of 7.8% in 2008/09, 2009/10, and 2010/11 (using a corporate tax rate of 30%).
- 2.9 The new transmission ("non-Part F") capital expenditure threshold will apply from 1 July 2008 until 30 June 2009 and thereafter, if Transpower proposes any "non-Part F" capital expenditure, the Commerce Commission will reset the threshold on an annual basis in accordance with the reset principles described in Schedule 2 of the Notice.
- 2.10 The System Operator Service Provider Agreement (SOSPA) threshold will apply from 1 July 2008 until 30 June 2011. If the system operator role is materially changed prior to 30 June 2011 and, at the time of the material change, the role is not contestable in the opinion of the Commerce Commission, then the Commerce Commission has the option to set a new System Operator services threshold. This threshold would effectively ensure compliance with the existing System Operator Service Provider Agreement between the Electricity Commission and Transpower, and does not impose any additional requirements.

- 2.11 Compliance reporting will be on an annual basis in a manner similar to the requirements in the Commerce Act (Transpower Thresholds) Notice 2007. Compliance reports will be required by 30 September each year for the assessment period ending 30 June prior. Transpower also proposes that compliance reporting for each of the transmission thresholds will be undertaken separately in respect of the high voltage alternating current (HVAC) revenue requirement and high voltage direct current (HVDC) revenue requirement.
- 2.12 The HVAC and HVDC revenue requirements for Transpower's 2006/07, 2007/08 and 2008/09 pricing years were determined prior to the date from which the settlement thresholds took effect. Although Transpower's new thresholds apply from 1 July 2008, its revenue in the 2006/07 and 2007/08 years is, in effect, subject to these thresholds (recorded by a deed) through the operation of its existing Economic Value Account framework in its current TPM. Transpower will make *ex post* adjustments to its Customer Accounts so that its total transmission revenue in each of 2006/07 and 2007/08 is the maximum amount it would have received in relation to the specified services had its revenue requirement for those pricing years complied with the settlement thresholds. The *ex post* adjustments, the 2007/08 non Part F threshold, as well as a requirement to report compliance regarding whether or not it has complied with the terms of the settlement in the 2008 financial year, are recorded as obligations in the administrative settlement.

Quality threshold

- 2.13 The Commerce Amendment Act (No 2) 2004 removed the Commerce Commission's previous ability under Part 4A of the Commerce Act to make an authorisation, or to accept an undertaking, in respect of all or any component of Transpower's quality standards. In approving the terms of the settlement, the Commerce Commission considered it appropriate to retain the quality threshold for Transpower in the same form for the remainder of the settlement period, at least until alternative service reporting obligations acceptable to the Commerce Commission are established.
- 2.14 The benchmark agreement and interconnection rules developed by the Electricity Commission (see paragraph 3.29) provide for the disclosure of quality-of-service measures in relation to transmission assets. The disclosure is, however, only to the designated transmission customer concerned, and not to all parties with a potential interest (the benchmark agreement applies by default if transmission agreements, consistent with the benchmark agreement, have not been agreed by 1 April 2008). The Electricity Governance Rules, however, provide for information on quality of service in relation to interconnection assets (the bulk of Transpower's assets are interconnection assets) to be made available to all interested parties.
- 2.15 The Commerce Commission indicated that retaining some incentives on Transpower's performance through the quality threshold would be more consistent with the purpose statement in Part 4A of the Commerce Act than removing Transpower's quality threshold entirely. It also provides for the disclosure of information on quality of service in relation to transmissions and interconnection assets to all interested parties.

Specified services under the price path threshold

- 2.16 Where transmission services are contestably or competitively provided, they can be excluded from the definition of services subject to the price path threshold, given that incentives for efficiency are provided through market processes.
- 2.17 Under the Commerce Act (Transpower Thresholds) Notice 2008, which remains in force until 30 June 2011, the following services provided by Transpower are among those excluded from the definition of “specified services” and therefore are not subject to the revenue requirement threshold:²
- (a) services that are not directly related to the provision of electricity transmission (e.g., consultancy or information services);
 - (b) services for which Transpower demonstrates beyond reasonable doubt there is workable or effective competition in their provision; and
 - (c) services provided by Transpower under new investment contracts, but in the case of new investment contracts entered into after 5 June 2003, only if the other party agrees in writing that the terms and conditions are reasonable or reflect contestable provision of the service.
- 2.18 In addition, the Commerce Act (Transpower Thresholds) Notice 2008 states that services provided by Transpower as a result of new investment can be excluded “if Transpower demonstrates beyond reasonable doubt that the new investment was approved under a process (whether regulatory or otherwise) that provides for affected customers to make and approve price/quality trade-offs and opportunity for competitive provision of new investment by parties other than Transpower”.³ Under the Commerce Act (Transpower Thresholds) Notice 2007, grid investments approved by the Electricity Commission under Part F of the Rules are not excluded services under this definition.
- 2.19 Investment contracts negotiated and agreed directly between Transpower and transmission customers are excluded from the definition of “specified services” only if the other party agrees in writing that the terms and conditions are reasonable or reflect contestable provision of the goods and services. Revenue from services directly associated with such investments would not be considered as part of the notional revenue calculation.
- 2.20 Section 54M of the Commerce Act provides that a breach of the administrative settlement may be dealt with under Part 6 of the Act as if the settlement were a customised price-quality path. This applies despite any terms of the administrative settlement. Before the expiry of the settlement, the Commerce Commission must recommend to the Minister that either Transpower is subject to default/customised price-quality regulation under subpart 6 of the Commerce Act, or subject to individual price-quality path regulation under subpart 7.

² Commerce Act (Transpower Thresholds) Notice 2008, clause 3(1), definition of “specified services”.

³ Commerce Act (Electricity Lines Transpower Thresholds) Notice 2007, clause 3(1)(i).

3. The Role of the Electricity Commission

Function of the Electricity Commission

- 3.1 A key function of the Electricity Commission is to recommend to the Minister of Energy the promulgation of Rules pursuant to section 172H of the Electricity Act. Part F of the Rules, which came into force in May 2004, contains the rules relating to electricity transmission and covers:
- transmission agreements (Section II);
 - transmission grid upgrades and investments (Section III);
 - transmission pricing methodology (Section IV);
 - financial transmission rights (Section V);
 - interconnection asset services (Section VI); and
 - preparation of an outage protocol (Section VII).
- 3.2 The Electricity Commission does not regulate Transpower's overall revenue requirement. The Electricity Commission is, however, required to advise the Commerce Commission of its decision to approve any grid-related expenditure.

Grid-Related Expenditure

- 3.3 Approval of grid-related investment is predominantly a matter for the Electricity Commission (Electricity Commission scrutiny is limited to proposed investments in the grid, or alternative arrangements proposed by Transpower).
- 3.4 The extent and timing of recovery for capital expenditure and all operational expenditure including that associated with that investment may be subject to the Commerce Commission's scrutiny. The Commerce Commission undertakes this assessment in accordance with its legal obligations under the Commerce Act.
- 3.5 Until the Electricity Commission has developed systems to review replacement and refurbishment type capital investments, the non Part F threshold applied to Transpower by the Commerce Commission will apply.
- 3.6 When the Electricity Commission approves an investment proposal, the approval is for the lesser of the project costs applied for (including contingencies) or the actual cost of implementing the investment proposal. This is for the purpose of establishing the "book value" for Transpower's regulatory asset base.
- 3.7 The Commerce Commission is required by s54V of Part 4 of the Commerce Act to take into account certain decisions of the Electricity Commission.
- 3.8 The Electricity Commission has no specific power under the Rules to audit Transpower's post-approval expenditure on an investment or whether Transpower has recovered costs in

accordance with the amount approved by the Electricity Commission. In addition, although the Electricity Commission's analysis makes assumptions regarding the timing of expenditure, the Electricity Commission's approval does not specify the appropriate timing for incurring or recovering expenditure associated with that investment. Importantly, the Electricity Commission's analysis only considers the net benefits, whereas s52A of the Commerce Act requires a wider evaluation by the Commerce Commission.

- 3.9 While the Commerce Commission does not expect that it would review the merits of the Electricity Commission's approval as a matter of course, during an investigation into a breach of the administrative settlement, the Commerce Commission may investigate how Transpower has:
- applied the approved costs (the lower of the approved or actual) i.e. at what amount and when have the approved assets been added to the regulatory asset base; and
 - translated the approved costs into prices for transmission services.
- 3.10 The Commerce Commission's assessment would not, for instance, involve rework of the grid investment test or an evaluation against the grid reliability standards or an investigation into the input methodologies the Electricity Commission has developed as part of the Rules.

Grid Upgrade Plan Approval Process

- 3.11 The Electricity Commission's role under section III of Part F of the Rules is to receive from Transpower investments in the grid comprising of grid upgrade plans disaggregated into reliability investments and economic investments. The Electricity Commission's function is to review and, if appropriate, approve such investments.
- 3.12 The relevant processes for Transpower to propose, and the Electricity Commission to assess grid investments, are set out in the Rules.
- 3.13 Other non-grid-related expenditure (with the exception of system operator services, which are constrained by a new threshold reflecting the value of the service provider agreement with the Electricity Commission) is constrained by the Commerce Commission's scrutiny of Transpower's internal policies and downward pressure on costs. This expenditure would not be examined unless a breach of a threshold occurs.
- 3.14 Given the requirement to distinguish between grid and non-grid-related expenditure, the Electricity Commission has, since the commencement of Part F of the Rules,⁴ been engaged in a process of discussion with Transpower to help clarify for Transpower which investment components can be assessed under Part F of the Rules where uncertainty exists.
- 3.15 For the bulk of Transpower expenditure, the categorisation of grid or non-grid-related expenditure is clear. For example, investment proposals to build new lines (with the associated capital costs of physical assets, cables, towers and substations and related project costs of land easement purchases and resource management approval processes) are clearly grid-related. System operation costs are non-grid-related expenditure.

⁴ Part F of the Rules commenced in May 2004.

- 3.16 Accordingly, the Electricity Commission and Transpower continue to develop processes and guidelines that facilitate the efficient proposal and assessment of grid investments within the Part F Rules framework, and provide guidance on what expenditure may be considered grid- and non-grid-related. In the meantime the Commerce Commission is approving some grid related expenditure under the administrative settlement.
- 3.17 These processes and guidelines reflect the specific nature of the expenditure components and endeavour to fit as much as possible with Transpower's existing internal capital expenditure approval and business planning processes. In particular, consideration of streamlined and bundled proposals and assessment of smaller projects (on a periodic cycle) such as replacement and refurbishment expenditure will be considered.

Grid Investment Test

- 3.18 In order to be approved, reliability investments and economic investments must satisfy the Grid Investment Test (GIT).⁵ The GIT is contained in schedule F4 of section III of Part F of the Rules.
- 3.19 In broad terms, the GIT sets out a cost-benefit framework for the analysis of reliability investments and economic investments proposed by Transpower. The analysis is required to take into account market benefits and costs of an investment that accrue over (at least) a 20-year period following the commissioning of the investment. The GIT also requires the market benefits and costs of a proposed investment to be compared to the market benefits and costs of a number of possible alternative projects.
- 3.20 A reliability investment, that is required to ensure the grid meets the basic reliability standard set out in clause 4.2 of schedule F3 (Grid Reliability Standards) of section III of Part F,⁶ satisfies the GIT if the Electricity Commission is reasonably satisfied that:
- the proposed investment maximises the expected net market benefit, or minimises the expected net market costs, compared with a number of alternative projects; and
 - if sensitivity analysis is conducted, a conclusion that the proposed investment satisfies the above is sufficiently robust having regard to the sensitivity analysis.
- 3.21 For all other reliability investments, and for all economic investments, the relevant investment satisfies the GIT if the Electricity Commission is reasonably satisfied that:
- the proposed investment maximises the expected net market benefit compared with a number of alternative projects; and
 - the expected net market benefit of the proposed investment is greater than zero; and
 - if sensitivity analysis is conducted a conclusion that the proposed investment satisfies the above is sufficiently robust having regard to the results of the sensitivity analysis.

⁵ Under rule 13.4 of Part F, Section III, reliability investments must also reflect good electricity industry practice in meeting the grid reliability standards, and comply with the processes set out in the Electricity Governance Rules. Under rule 14.4, Transpower must also follow any agreed consultation process in order for an economic investment to be approved.

⁶ This clause of the grid reliability standards is commonly referred to as the "N-1 Safety Net".

Bilateral investment Contracts

- 3.22 The GIT does not apply where Transpower has been able to directly agree a bilateral (or multilateral) investment contract with one (or more) of its transmission customers.⁷ The Electricity Commission has indicated that it does not intend to interpose itself between Transpower and parties with which it has such investment contracts.⁸ The TPM provides for the capital charges to be calculated in accordance with the bilateral investment contract.

Incentives

- 3.23 The grid upgrade plan process and Part 4 of the Commerce Act together are designed to place incentives on Transpower to seek Electricity Commission approval for all significant grid expenditure (and all significant grid expenditure components). Under the administrative settlement, Transpower cannot recover such expenditure unless it has been approved by the Electricity Commission.

Revenue Requirement

- 3.24 The Government Policy Statement provides that Transpower should determine its total revenue requirement – covering both sunk and new investments – subject to the constraints of Part 4A of the Commerce Act, and that Transpower should submit grid upgrade plans to the Electricity Commission for approval. Such plans should demonstrate that the proposed expenditure is required to meet reliability standards and/or deliver the greatest net benefit after taking into account transmission alternatives.
- 3.25 The Government Policy Statement states that, where the Electricity Commission approves a Transpower-proposed investment, the cost of that investment should be recoverable by Transpower in accordance with the TPM determined by the Electricity Commission.⁹

Approval of Transpower's transmission pricing methodology

- 3.26 Section IV of Part F of the Rules contains the rules dealing with the development and approval of the TPM.
- 3.27 The TPM is intended to determine how Transpower's revenue requirement from the majority of its services will be recovered from transmission customers under transmission agreements for connection to and use of the grid. The Government expects transmission services to be priced as efficiently as possible and, subject to the Commerce Act, Transpower's charges should recover the full economic cost of its services.¹⁰

⁷ Electricity Governance Rules, Part F, Section III, rule 8; and Electricity Governance Rules, Part F, Section III, Schedule F4 – Grid Investment Test, clause 32.

⁸ Electricity Commission, *Explanatory Paper: Grid Investment Test*, 3 December 2004, para 77.

⁹ *ibid*, para 98.

¹⁰ *ibid*, paras 107 and 108.

Benchmark Agreement and interconnection rules

- 3.28 The benchmark agreement and interconnection rules set by the Electricity Commission were gazetted in late May 2007. The benchmark agreement deals with connection services (i.e. with connection to the grid and the use of connection assets) and interconnection information services, while the interconnection rules deal with interconnection asset services.
- 3.29 The benchmark agreement and interconnection rules provide for service measures, and for service levels to be established for those service measures, for connection and interconnection services, and various information-only reporting requirements. These reporting requirements include requirements to provide information on the reliability and availability of grid assets. These reliability and availability reporting requirements were set having regard to the Commerce Commission's quality thresholds, in order to minimise the extent to which Transpower would be required to undertake additional reporting.
- 3.30 The benchmark agreement and interconnection rules also set out procedures to be followed if an asset does not meet or is unlikely over the next five years to meet the Grid Reliability Standards. These could result in investments by Transpower either by agreement with customers in respect of connection assets, or through the application of the GIT, as discussed above.
- 3.31 Section VII was added to the Rules to provide for the making of an outage protocol, which requires Transpower to plan for outages and to deal with unplanned outages.¹¹ The outage protocol was initially developed by Transpower, and was then consulted on by the Electricity Commission and gazetted late December 2007. The Electricity Commission does not consider that the outage protocol imposes any requirements that are inconsistent with the Commerce Commission's quality requirements.

¹¹ Section VII of Part F of the Rules

5. Achieving Operational Coordination between the Commerce Commission and the Electricity Commission

- 5.1 This section sets out an explanation as to how issues relating to valuation methodologies, capital expenditure approval, pricing and pricing methodologies, quality and information disclosure are coordinated and harmonised where possible between the two Commissions. The matters raised in the first and second bullet points in paragraph 118 of the Government Policy Statement have been addressed in subsections 1.3–1.8 and section 3, respectively. This section is intended to specifically address the questions in the third bullet point in paragraph 118 of the Government Policy Statement. The order of discussion follows the natural progression of building an annual revenue requirement, turning this into prices, and then testing performance against the thresholds.

Valuation of Transpower's Regulated Asset Base and Capital Expenditure Approval

- 5.2 Under subpart 3 of Part 4A of the Commerce Act (Information Disclosure) the Commerce Commission requires that Transpower's regulated asset base (RAB) be valued using the depreciated historic cost (DHC) principles:
- The DHC asset value included in the RAB as at 30 June 2006 is the optimised deprival value (ODV) of Transpower's system fixed assets and other assets used to provide specified services as at 30 June 2006;
 - Transpower's assets acquired since 30 June 2006 cannot be included in the RAB unless the asset is used to provide specific services and has been approved by the Electricity Commission under Part F of the Electricity Act, or has been approved by the Commerce Commission under the ("non-Part F" capital expenditure) threshold or other administrative settlement terms.
- 5.3 The Electricity Commission's grid upgrade approval process under Part F of the Rules does not deal directly with valuation methodologies and nor does the TPM require alignment with valuation methodologies.

Revenue Requirement

- 5.4 Under the settlement agreement, Transpower sets its own annual AC and HVDC revenue requirements subject to the constraints in the settlement agreement. Once set, the revenue requirement is allocated to customers by Transpower according to the TPM.

Transmission Pricing Methodology

- 5.5 The TPM is a mechanism to appropriately apportion Transpower's revenue requirement to customers. The TPM is approved by the Electricity Commission and applied by Transpower. The Electricity Commission may audit the application of the TPM to confirm

whether the transmission prices have been calculated in accordance with the methodology. The auditor's report will consider whether the application of the TPM contains errors or inconsistencies that may have a material impact on the prices of any individual transmission customer, or transmission customers in general.

- 5.6 The Commerce Commission does not typically scrutinise the apportionment of prices. Likewise, the TPM has no bearing on the revenue requirement approved by the Commerce Commission, or on compliance with that revenue requirement (threshold).

Revenue Requirement Threshold

- 5.7 While Transpower is not subject to a revenue cap under the administrative settlement, it is subject to a principle-based threshold that sets the constraints within which Transpower will set its annual revenue requirement. Both the revenue requirement and non Part F threshold, as well as the Electricity Commission's scrutiny of capital expenditure, apply checks and balances to Transpower's operations.
- 5.8 As mentioned above, the revenue requirement threshold does not consider the TPM or how prices have been allocated to customers. If Transpower's prices generate more or less revenue than specified by the revenue requirement threshold, Transpower will make adjustments to its Economic Value Accounts to net off the over or under recovery. If Transpower fails to make such an adjustment in the case of over recovery, it will breach the threshold.
- 5.9 If a breach occurs, the Commerce Commission will investigate the breach, and consider whether to seek penalties and compensation under Part 6 of the Commerce Act.

Settlement arrangements

- 5.10 The Commerce Commission and the Electricity Commission have co-operated to ensure, as far as practicable, that the administrative settlement does not:
- inhibit the Electricity Commission's ability to approve transmission investments it considers should be approved;
 - prevent the Commerce Commission from exercising the required oversight of Transpower to ensure the purpose of Part 4 of the Commerce Act is fulfilled; and
 - prevent Transpower from earning an appropriate return on its approved investments and regulatory asset base.

Grid Upgrade Plans

- 5.11 Grid-related expenditure approved by the Electricity Commission will only be investigated by the Commerce Commission if concerns arise under section 52A of the Commerce Act from an investigation of an alleged breach of the administrative settlement. If the Commerce Commission determines that such expenditure is reasonable in all the circumstances, then no further action will be taken.

Quality

- 5.12 The Commerce Commission will liaise with the Electricity Commission and keep it informed of relevant information with respect to any investigation into any alleged breach of quality requirements.